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March 2, 1999

David Waddell
Executive Secretary
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, TN 37243-0505

In Re: Application of BellSouth BSE, Inc. for a Certificate of Convenience and
Necessity to Provide Intrastate Telecommunications Services
Docket No. 98-00879

Dear Mr. Waddell:

Enclosed is the direct testimony of Joseph Gillan filed on behalf of Southeast
Competitive Carriers Association in the above-captioned docket.

Very truly yours,

BOULT, CUMMINGS, CONNERS & BERRY, PLC


Henry Walker

HW/nl
Enclosure
c: Parties

BEFORE THE TENNESSEE REGULATORY AUTHORITY
Nashville, Tennessee

In Re: Application of BellSouth BSE, Inc. for a Certificate of Convenience and
 Necessity to Provide Intrastate Telecommunications Services
 Docket No. 98-00879

DIRECT TESTIMONY OF JOSEPH GILLAN

1 **Q. Please state your name, business address and occupation.**

2 A. My name is Joseph Gillan. My business address is P.O. Box 541038, Orlando,
3 Florida 32854. I am an economist with a consulting practice specializing in
4 telecommunications.

5
6 **Q. Please briefly outline your educational background and related experience.**

7 A. I am a graduate of the University of Wyoming where I received B.A. and M.A.
8 degrees in economics. From 1980 to 1985, I was on the staff of the Illinois Commerce
9 Commission where I had responsibility for the policy analysis of issues created by the
10 emergence of competition in regulated markets, in particular the telecommunications
11 industry. While at the Commission, I served on the staff subcommittee for the NARUC
12 Communications Committee and was appointed to the Research Advisory Council
13 overseeing NARUC's research arm, the National Regulatory Research Institute.

14
15 In 1985, I left the Commission to join U.S. Switch, a venture firm organized to develop
16 interexchange access networks in partnership with independent local telephone companies.
17 At the end of 1986, I resigned my position of Vice President-Marketing/Strategic Planning
18 to begin a consulting practice.

19
20 Over the past decade, I have provided testimony before more than 25 state commissions, four
21 state legislatures, the Commerce Committee of the United States Senate, and the

1 Federal/State Joint Board on Separations Reform. I currently serve on the Advisory Council
2 to New Mexico State University's Center for Regulation.
3

4 **Q. On whose behalf are you testifying?**

5 A. I am testifying on behalf of the Southeast Competitive Carriers Association
6 (SECCA). SECCA is an association with a broad membership, committed to the
7 development of competition across all services and all areas of Southeast.
8

9 **Q. Please explain the fundamental issue in this proceeding.**

10 A. On December 8, 1998 the Tennessee Regulatory Authority (TRA) authorized
11 BellSouth BSE to offer competitive local exchange services in areas *not* already served by
12 BellSouth BSE's affiliated incumbent local exchange carrier, BellSouth Telecommunications
13 (BellSouth-LEC). The principle issue of that proceeding was the question "just how many
14 BellSouths does it take to provide local service in its one territory?" The Commission
15 correctly responded "just one," and limited BellSouth BSE to offering service in those
16 portions of the state where it would participate as a legitimate entrant, seeking to win
17 customers from an unaffiliated incumbent, and paying that incumbent real dollars for
18 whatever services and/or network elements it required. The question for this proceeding is
19 simply "has anything materially changed?"
20

21 In the testimony that follows, I reiterate the correctness of the TRA's original conclusion.
22 Because *consumers* will discern only one BellSouth -- and *investors* will evaluate only one
23 BellSouth -- no valid purpose would be accomplished by a regulatory system that pretends

1 that there are two. In fact, in the time since BellSouth's application was originally
2 considered, BellSouth's own marketing *confirms* SECCA's concern that BellSouth would
3 deliberately advertise to reinforce a "single BellSouth" image in the minds of consumers.
4 There is no material difference between this application and its predecessor, and the TRA
5 should reject BellSouth's request to "compete" against itself through the legal fiction of
6 BellSouth BSE.

7
8 **Q. What changes has BellSouth proposed to its original application?**

9 A. BellSouth has offered two changes to its original application:

10 1. BellSouth BSE would voluntarily agree that it would not offer retail prices
11 below BellSouth-LEC's wholesale rate -- at least without permission.

12 2. BellSouth would agree to establish BellSouth BSE in accordance with Section
13 272 of the Telecommunications Act.

14
15 Neither of these modifications, however, reduces the potential for competitive harm,
16 discrimination and customer confusion that justified the TRA's initial decision.

17
18 **Q. Is BellSouth's conditional promise to never "price below its wholesale cost"**
19 **meaningful?**

20 A. No. Only BellSouth-BSE enjoys an identity of ownership with BellSouth-LEC. As
21 such, there is shareholder-indifference within BellSouth as to whether a service is sold by
22 BellSouth-LEC or BellSouth-BSE. The effect on the parent -- BellSouth's -- investments,

1 expenses, revenues and, ultimately, profits is identical. When you own the pants, it does not
2 matter in which pocket you keep your money.

3 This fundamental difference between BellSouth BSE and a legitimate reseller is illustrated
4 by the uselessness of the pledge that BellSouth offers here. BellSouth BSE only promises
5 to not price *below* its affiliate's wholesale price. A legitimate entrant, however, could not
6 survive if it simply recovered the cost of its wholesale service. A legitimate entrant must
7 also recover its costs to market the service, provide customer support, and provide a return
8 to its investors. Thus, BellSouth's proposed "solution" to the danger of a price-squeeze is a
9 conditional promise which would, in fact, allow a price-squeeze to occur.

10
11 Furthermore, BellSouth BSE has previously testified that it will typically offer local service
12 as part of a package with other services. There is nothing in its proposal that would prevent
13 it from offering a "below wholesale" price by simply discounting the prices of other
14 components in the package. The "promise" that BellSouth offers does not correct the
15 "problem" -- fundamentally that BellSouth BSE *is not* an independent economic entity -- and
16 its meaningless commitment does not alter this basic fact and the incentives that follow from
17 it.

18
19 **Q. Are there other characteristics of service-resale which inherently favor an**
20 **ILEC-affiliate like BellSouth BSE?**

21 A. Yes. Service-resale uniquely advantages an ILEC's affiliate and is inherently
22 discriminatory. A wholly-owned affiliate like BellSouth BSE is interested in resale only

1 because it has none of the financial and market constraints that would affect a legitimate
2 entrant.

3
4 For instance, under service resale, the ILEC (BellSouth-LEC) continues to receive access
5 revenues for each of the reseller's customers. In effect, the reseller is nothing more than an
6 uncompensated marketing agent for the ILEC's access service. While this relationship is
7 acceptable to BellSouth BSE, no independent CLEC could succeed in such a role.

8 Furthermore, the defining constraint of resale that the CLEC-reseller can only offer
9 services identical to those of the incumbent actually works to BellSouth BSE's
10 advantage. Far from being concerned with an inability to establish a unique product,
11 BellSouth BSE *wants* consumers to perceive it as no different than BellSouth-LEC.
12 As explained later in this testimony, BellSouth BSE's *goal* is trade on BellSouth-
13 LEC's monopoly legacy and reputation, and has neither the intent nor the need to
14 distinguish itself. Because of the inherent limitations of service resale, virtually
15 every carrier that has tried to compete using service resale -- at least, every
16 *unaffiliated* carrier -- has terminated its resale activity.

17
18 **Q. If not for the discriminatory advantages made possible by its wholly-owned**
19 **affiliate status, would it otherwise make sense for BellSouth BSE to "compete" with**
20 **BellSouth-LEC as a reseller?**

21 A. No. Service-resale is only financially viable if the entrant can provide marketing and
22 customer support more efficiently than the incumbent -- and not just modestly so, but by at
23 least an amount necessary to offset any price discount needed to attract the customer. Apply

1 this equation to the operations of BellSouth-BSE. Is there any reason to believe that
2 BellSouth-BSE can provide marketing and customer service more efficiently than BellSouth-
3 LEC -- and, if BellSouth-BSE could, shouldn't BellSouth-LEC adopt its practices?

4 *The only reason that service-resale is attractive to BellSouth-BSE is because the*
5 *fundamental economics of service resale do not apply.* Each dollar BellSouth-BSE pays for
6 the services it resells it pays to a sister company; its marketing costs are reduced because it
7 benefits from each advertisement run by its sister company; the price discounts it must offer
8 to attract customers from BellSouth are reduced because it will be perceived *as* the
9 incumbent; and the profitable access revenues of its customers are retained by the parent.
10 BellSouth-BSE is an accounting fiction, immune from the standard financial constraints of
11 its chosen entry strategy.

12
13 **Q. Should the Commission expect consumers will be able to distinguish between**
14 **BellSouth-LEC and BellSouth-BSE?**

15 A. No. As Mr. Scheye pointed out in his testimony, BellSouth BSE is now offering
16 service in Tampa, Florida. Attached is an advertisement that BellSouth recently placed in
17 Florida Magazine announcing this entry. This advertisement is clearly intended to promote
18 the image of a single BellSouth -- the company that has offered local services in Florida for
19 100 years -- in the minds of consumers. Although the advertisement references "BSE," it
20 does so only in the advertisement's final line. As this advertisement demonstrates, the
21 concept of an independent "BSE" is a legal fiction, not a market reality.

22 While BellSouth wants to portray BellSouth BSE as "...any other competing
23 telecommunications carrier ("CLEC")...", the truth is that BellSouth BSE is a

1 transparent extension of BellSouth-LEC, the exchange monopolist. This position of
2 incumbency provides BellSouth certain market advantages (like already serving *all*
3 of the local customers in its territory). As the TRA recognized, both the state and
4 federal statutes have imposed specific obligations on BellSouth to curb its ability to
5 exploit the advantages of exchange monopoly. By creating a legal entity that is
6 imperceptibly different in the market -- but which is subject to none of the
7 obligations of an incumbent carrier -- BellSouth is able to retain all the market
8 advantages of incumbency while gaining all the flexibility of non-dominance. This
9 strategy provides BellSouth its desired deregulatory freedom, without the
10 inconvenience of actually losing any market-control.

11
12 **Q. What would be the effect of BellSouth being able to compete in the same market**
13 **through two legal entities, but one market presence?**

14 A. It is impossible to predict with certainty *every* problem that would be created by
15 authorizing BellSouth to offer the same set of services through two entities -- each subject
16 to different rules and obligations -- in the same market. However, there are a number of
17 adverse consequences from their proposal that are immediately apparent.

18
19 For instance, BellSouth would be able to improperly benefit its unregulated affiliate through
20 costs incurred by its regulated twin. BellSouth recently announced a \$20 million advertising
21 campaign intended to promote "BellSouth's" technological skills. Like all product non-
22 specific advertising, these adds will promote BellSouth-BSE and BellSouth-LEC without

1 differentiation. (In fact, it is difficult to conceive of any advertisement that includes the
2 BellSouth name and logo that would not benefit BellSouth-BSE.)

3
4 BellSouth-BSE would also provide BellSouth the ability to discriminate in favor of select
5 customers by offering targeted products through BellSouth-BSE that are not generally
6 available to other BellSouth customers. BellSouth could also use BellSouth-BSE try to
7 avoid its obligations under the federal Act, in particular its obligation to permit the
8 unrestricted resale of its services at wholesale rates. The premise of the wholesale pricing
9 option is that the relevant "retail" price is the tariffed rate of the incumbent local exchange
10 carrier, in this case BellSouth-LEC. Approving BellSouth-BSE would violate this principle
11 by providing BellSouth *two* legal entities -- yet a *single* market presence -- to offer its local
12 services. BellSouth would be able to reprice existing services and introduce new ones
13 through BellSouth-BSE, potentially without an obligation to offer a wholesale equivalent
14 subject to the appropriate discount. In effect, the "retail" price *relevant* to consumers would
15 be different than BellSouth-LEC's list price to which the wholesale-discount obligation
16 applies.

17
18 **Q. Does BellSouth BSE's willingness to comply with Section 272 of the**
19 **Telecommunications Act fundamentally alter your conclusions?**

20 A. No. This "concession" is nothing more than the sleeves from BSE's vest. Mr. Scheye
21 acknowledges that it must conform to Section 272 in order to provide interLATA services.
22 More to the point, however, this proposal does nothing to eliminate the competitive concerns
23 discussed above.

1
2 **Q. Mr. Scheye implies that the TRA is somehow "out of step" with its decision to**
3 **limit BellSouth BSE's certificate. Has the Texas Public Utility Commission**
4 **addressed a similar issue with respect to GTE?**

5 A. Yes. The Texas PUC rejected a similar twin-provider request with the legal-rationale
6 that its state statute did not contemplate issuing two types of certificates in the same territory
7 to the same company or an affiliate. The Commission's press release expounded on its
8 reasoning as follows:

9
10 "If we allow regulated companies to use an affiliate in their own territory to avoid their
11 responsibilities and to enter the competitive market, we make a mockery of the whole
12 regulatory and legal scheme," said Commissioner Judy Walsh. Both Walsh and Chairman
13 Pat Wood, III, said that letting GTE's affiliate compete in GTE's service area would be
14 counter productive to the competitive local telephone market the PUC is working to establish
15 in Texas.

16
17 Furthermore, Mr. Scheye characterizes the FCC as supporting the proposition that ILECs
18 should "compete" with themselves through the use of an affiliate similar to BellSouth BSE
19 in the context of advanced data services. Although the FCC is *considering* whether an
20 affiliate that is "truly separate" should be allowed to compete in this way, it *has not* reached
21 a decision as to what restrictions must be met before an affiliate would be considered to
22 satisfy the "truly separate" standard. Furthermore, the FCC's investigation is focusing on a
23 specific technology (xDSL service) which assumes that the affiliate obtains collocation and

1 network elements from the ILEC at *cost-based* rates -- a fundamentally different
2 arrangement that does not involve the inherently discriminatory conditions of service-resale
3 described above.

4
5 **Q. Has the Kentucky Public Service Commission addressed the issue of**
6 **certificating BSE in BST's territory?**

7 A. Yes. Although the Kentucky Public Service Commission is reconsidering its
8 decision in a generic docket to look at both GTE and BST, the Commission has refused to
9 grant BSE a certificate to operate as a "CLEC" in BST's service territory. *See* Order of KY
10 PSC in 97-417.

11
12 **Q. Should the Commission approve BellSouth-BSE's certificate and just wait to**
13 **address any problems that arise?**

14 A. No. As the TRA itself wrote in its *Order* of December 8, 1998, after-the-fact
15 enforcement may not be sufficient to protect competitors from harm. The TRA held (at page
16 12):

17 The Authority is unconvinced, however, that merely reacting to complaints satisfies
18 the Authority's responsibilities under TCA § 65-5-208(c). Moreover, the Authority
19 is equally convinced that it cannot expeditiously and effectively take peak [*sic.*]
20 actions necessary to counter any negative effects of anti-competitive behavior once
21 such effects have been experienced by competitors. In fact, it is questionable
22 whether the Authority could ever actually reverse any substantiated harm.

1 The problems created by BellSouth-BSE's certification within BellSouth-LEC's franchised
2 area are structural and systemic to its proposal. The concerns identified are not idle
3 speculation, but are the easily predictable consequences of creating the incentives that lie at
4 the heart of its request.

5
6 The fact of the matter is that BellSouth-BSE *is* BellSouth in the eyes of both consumers and
7 investors -- and, as such, is not an independent economic unit in any meaningful way. The
8 Commission should not allow BellSouth to use the legal pretense of a separate BellSouth-
9 BSE to accomplish through the back-door a level of deregulation that its rules, Tennessee
10 statute, and the federal Act would not grant directly.

11
12 **Q. Does this conclude your testimony?**

13 **A. Yes.**

CERTIFICATE OF SERVICE

The undersigned certifies that a copy of the foregoing has been hand delivered or mailed to the following persons on this the 2nd day of March, 1999:

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